School for Traders & Investors

Twentieth Lesson

Dealing in Privileges

Puts, Calls, Spreads and Straddles Explained

EVERYONE is familiar with the fact that options on property are in every-day use in ordinary business activity. How such options may be used in market transactions, and their value as insurance, is discussed in this instalment of the School for Traders and Investors.

LIMITING the risk is one of the important principles of success in business, whether it be related to manufacturing, mining, dealing in stocks, or any other activity where influences, the force and effect of which can be only approximated, may operate for or against original plans.

If an individual or corporation is considering the purchase of a factory, the buyer is sometimes granted the privilege of either purchasing for cash, or taking an option to purchase with the right to operate the factory for a limited period with a view to determining whether it is worth the price demanded. This option privilege may cost something, but it is probably worth the extra expense because it serves to *secure the right* to purchase, and at the same time, *limits the risk* in the event that final purchase of the plant is found to be unwarranted.

On the other hand, if the operations during the trial period are even more satisfactory than anticipated, and indicate that the plant is a great bargain at the stipulated price, the buyer does not regret the extra cost of the option, for although it is now demonstrated that the expense was unnecessary, he considers the cost as he would a fire insurance premium, which might have prevented a very large loss had he purchased outright and subsequent operations had proven disastrous.

Under analogous conditions, a mining corporation may have under consideration an attractive mining property. The owner may demand a price that appears unreasonable in the light of insufficient ore reserves to justify his demands. If the price is paid, the buyer runs the risk of a large loss should the mine fail to yield considerably more marketable ore than is immediately available at the time the purchase is made. However, the buyer may be able to negotiate an option to purchase the property at some future date, so that he may have time to develop the mine and find out whether it is worth less than the stipulated price, or many times its present alleged value. The details of the operating lease are peculiar to the mining business and need not be reviewed here, but the general principle involved in the expenditure for the option privilege before assuming the entire risk of outright purchase, is sound, and serves as an illustration of the limitation of risk in the mining business.

The same principle is applied in stock-trading operations by means of "puts" and "calls" and their combinations. A "put" is a contract that gives the holder thereof the right to *deliver* a certain quantity of stock, at a specified price, within a limited time. The price stated in the "put" is always below the market price at the time the "put" is issued. The agreement is substantially as follows:

"New York, Dec. 3, 1923.

For value received, the bearer may deliver to me 100 *shares of Bethlehem Steel at* 51, *at any time within thirty days from date. All dividends for which the books close in the meantime go with the stock. Expires January* 3, 1924, *at* 1.30 *P.M.*

John Doe."

The value of a "put" depends on the time it has to run and the proximity of the market price of the stock to the price at which the "put" is issued. If Bethlehem Steel is selling at 54 at the time the "put" is written, it would be worth about $150. If the market price of Bethlehem Steel were 53, the value might be greater, depending upon the number of similar contracts outstanding, and John Doe's estimate of the stock's technical position.

The seller of such a "put" believes that Bethlehem will sell at a higher price within the thirty days, and that if the stock is "put' 'to him, he will get it at a price 3 points below the present market, and as he has received $150 for the privilege, the net cost to him will be only 49½. If the stock is not "put" to him, and the contract expires by limitation, the price charged therefor is clear profit, aside from its small share of operating expenses. On the other hand, if the price of the stock declines, it can go as low as 49½, or decline 3½ points, before the seller will sustain a loss.

The buyer of the "put" is in the opposite position. He believes that the market is going down and that Bethlehem will decline below 49½ before his privilege has expired. If he is right, he will purchase the stock below 49½ before his option expires and "put" it to John Doe, thus making a profit represented by the difference between 49½ and whatever lower price he pays for the stock. He must be able to buy the stock at 49½ in order to get out even, and if the stock advances, contrary to his expectations, he may let this privilege expire, and his loss will be limited to the cost thereof.

The "put" may also serve the purpose of a stop-loss order. For example, suppose a trader has bought 100 Bethlehem at 51 and wishes to be insured against any material loss during the next thirty days. He may buy a privilege like the above, paying $150 therefor. This will enable him to "put" or deliver the stock to John Doe at 51. No matter to what price the stock may decline during the thirty-day period, the trader may deliver 100 shares at 51 at any time within that period, thereby limiting his loss to the cost of the "put." Approximately the same protection might be secured by a 1½-point stop, except that in a sharply declining market, the loss might be fractionally greater, for it must be remembered that his order is to "sell at the market" when the stop price is reached.

A "call' is virtually the reverse of a "put." It is a contract that gives the holder thereof the right to "call" upon (buy from) the maker of the privilege, for a certain quantity of stock, at a specified price, usually above the market, within a limited time. The substance of such a privilege is expressed as follows:

"New York, Dec. 3, 1923.

For value received, the bearer may call upon me for 100 *shares of American Locomotive at* 75, *at any time within thirty days from date. Expires January* 3, 1924, *at* 2.00 *P.M.*

John Doe."

John Doe is willing to sell this "call" because he does not believe the stock will sell much above 75 during the time specified, but estimates that it will decline. He

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ments in this field, odd lot buyers should be relieved of any handicaps which now exist in the matter of time and facility with which such orders are executed. We feel confident that methods will be worked out that will reduce the required time for execution to seconds instead of minutes, thus bringing the odd lot buyer closer to the real market and adding to his trading facilities.

Closer supervision and control of manipulative operations should be a natural outgrowth of the questionable methods that are at present frequently employed by large operators.

More frequent, and certainly at least quarterly, reports should be made by all corporations whose shares are listed on the Stock Exchange. Not to do this is to continue to force the public to discriminate against certain securities for this reason, and to keep the latter under the suspicion of being, to a certain extent, blind pools.

Stock quotations will doubtless be broadcasted by radio at frequent intervals during market sessions, instead of as now, hours after the market has closed. This will greatly widen the interest in the security markets and will undoubtedly go hand in hand with the development of broadcasting of general news, thus anticipating the frequent editions of newspapers.

Federal laws should demand full publicity by those who undertake to finance corporations and float securities. Strict control of the distribution of new securities should accompany such regulations. It will, of course, be difficult to control get-rich-quick operations, for people in any stage of our country's development will doubtless be gullible to a great extent, but education and regulation can accomplish much in this respect. Better and stronger laws should yield increased protection. Bucket shops will doubtless spring up in one form or another, but the net should gradually be tightened so that in time it should be impossible for them to operate.

Consolidation of all the United States railroads into a few large transportation units will doubtless be accomplished within the next decade. Naturally, this will lead to a reduction in the number of railroad securities in the stocks available in the Stock Exchange, but the aggregate of industrial and miscellaneous issues should increase in a still larger ratio.

Wall Street should more than ever be recognized as the financial center of the world.

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has in his possession 100 shares of American Locomotive bought at a lower price, and is therefore willing to have it called at 75.

The buyer of the privilege pays $200 for it and waits until, say, December 20th, at which time American Locomotive may have advanced to 80. He then sells 100 shares short at that price, and is in a position to secure a small profit by exercising his privilege if he chooses to do so.

However, he does not immediately "call" the stock, as the privilege has several days to run, and he believes the stock will again decline to a figure below the "call" price before the contract expires. He reasons that he now has a gross profit of 5 points, but he will wait, and if the market declines, as he expects, he may be able to cover his short at 70.

Suppose conditions favor him. He ignores the "call" and covers his short stock at 70, thus making a gross profit of 10 points. Deducting the cost of the "call" at $200, together with commission and tax amounting to $34, he has a net profit of $766 on the transaction.

A "spread" is another form of privilege which combines the "put" and "call." The terms of such a contract may be expressed briefly as follows:

> *"New York, Dec* 3, 1923.
> *For value received, the bearer may deliver to me* 100 *shares of Union Pacific at* 125, *or call upon me for* 100 *Union Pacific at* 135, *at any time within* 60 *days from date.*
> *Expires Febr.* 2, 1924, *at* 1.45 *P.M.*
> *John Doe."*

Another form of privilege is called a "straddle." It differs from the "spread" in that it gives the holder the right to "put" or "call" a stipulated number of shares of a certain stock at the same price. For example, a "straddle" on 100 Baldwin at 127 would include the privilege of either "calling" 100 at 127, or "putting" 100 at 127 at any time within the period covered by the contract.

The use of privileges may be advantageous to the trader in several ways. They may be bought simply for purposes of speculation, with the idea of exercising them when they show a profit. They may be used as a protection against either long or short trades, in which event they serve the purposes of stop-loss orders without the disadvantage of being placed "on the floor" where stop orders might be inviting to specialists in thin-market issues. They afford many opportunities for profitable transactions, which might not otherwise be available. One great advantage in their use is that the trader's possible loss is absolutely limited to the cost of the privilege. Another advantage of the privilege is that the trader may thereby secure an option on a speculative position without tying up funds required to finance the ordinary trade until he decides to exercise the privilege.

The student may properly ask the question: "If a trader can make any money by dealing in privileges, how does the maker of privileges secure any profit?" The answer is that the underlying theory of the business involves two general principles: first, the general principle of the fire-insurance company, which must so regulate its rates and terms of settlement that its income from premiums will be greater than its losses in settling risks over a reasonable period of time; and, second, the mathematical principle of the roulette wheel, where the general probabilities are so arranged that there is a "percentage in favor of the game." In the "put" and "call' business, the variable factors that must be adjusted are the price to be charged for the privilege, and the relation between the market price of a stock and the "put" or "call" price. These factors are determined from experience, just as proper fire and life insurance premiums, and terms of settlement, have been determined on the basis of experience, plus the consideration of certain well known mathematical principles involving compound interest and probabilities.

The "put" and "call" broker serves two general classes of clients. Perhaps the more important ot these is the methodical trader who makes use of such privileges for the protection of trades and the limitation of losses. He regards the cost of his privilege in somewhat the same light as he would regard a fire-insurance premium. From the examples hereinabove cited, it will be observed that both parties interested in the "put" or "call' privilege may make a profit by the exercise of the privilege, and that charges for privileges that are not exercised are nearly clear profit to the maker thereof.

The other type of client served by the "put" and 'call" specialist is the average market speculator or gambler who pits his "guess" against the specialist's "knowledge and experience."

Every privilege purchased by a trader should be guaranteed by a member of the New York Stock Exchange. Privileges endorsed by one member of the exchange may be exercised through any office of any other member. These privileges should be purchased from recognized specialists, whose reputation is beyond question.